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The Banking Bill as It Passed the House.

BY A. PIATT ANDREW,

Formerly Assistant Secretary of the Treasury.

(From the Boston Evening Transcript of October 8, 1913.)

The Banking Bill, as it passed the House on September 18th, contains, it is said, more than four hundred changes from the bill as introduced by Chairman Glass on June 26th. Certainly some of the more glaring crudities of the original bill have been eliminated. Vanished for instance from section 17 is the odd provision that the notes are to "purport on their faces (sic) to be the obligations of the United States," a clause which indiscreetly revealed the reluctance with which the sponsors for the bill had stooped to conquer the greenback faction of their party. Gone too is the curious provision of section 15 that the discount rate shall be fixed with a view to "promoting a stable price level" which was not improbably another concession made in deference to the same faction. In the course of three months' discussion in the House Banking and Currency Committee (a committee which it will be recalled was not appointed until June, 1913, and therefore had had no part in the original framing of the bill) many other crudities have been effaced, many extremely objectionable provisions have been modified and many improvements of detail have been introduced. Nevertheless a careful reading of the modified bill leads me to reaffirm many of the conclusions with regard to the original bill which I expressed in these columns on June 26th.

Too Many Reserve Banks.

First, the number of proposed reserve banks remains as before "not less than twelve," so many as to leave partial and uncertain the mobilization of reserves which it is the primary and essential object of banking reform to establish, and

in fact so many as to suggest grave doubts even as to the possibility of organizing the required number. If there were twelve separate organizations there would be twelve separate reserves, some of them of quite unimposing dimensions and all of them subject to the varying and competing interests of the twelve sections of the country in which they were located. They would not insure the country against sectional struggles for reserves, stoppages of domestic exchange and general bank suspensions, which have been the most serious evils of our banking system in the past. To be sure, under the provisions of the bill these sectional reserves could be redistributed among the different reserve banks at the discretion of the government board at Washington, but it is scarcely believable, that this power could be freely exercised by such a board without arousing ill will, and sometimes actual hostility and resistance, without, in fact, endangering the continued existence of the whole reserve bank system.

Moreover, and this would seem rather serious from a practical point of view, it is at least doubtful whether the twelve banks required by the bill could be organized. If the state banks and trust companies, as is probable, withheld from the system, even if all of the national banks joined, which is improbable, owing to the concentration of national bank capital in a few of the principal cities, it would require a very careful adjustment of the districts to provide enough national bank capital to establish twelve $5,000,000 reserve banks. Certainly the bill would be greatly improved, not only as a working measure, but as a practical possibility, if the words "not more than twelve" were to be substituted for the words "not less than twelve." This would allow the project to start with three or five, or whatever smaller number of institutions the banking situation and political expediency might require, and it would be much easier to increase the number later on than to decrease it, if subsequent experience suggested the advisability of a change.

Politics and Banking.

Second, the proposed method of management is still open to partisan abuse and almost sure to involve the banking system in political controversy. Each incoming administration is still to have two of its cabinet officers, one bureau chief and two additional appointees—five in all—among the seven members of the Federal Reserve Board, and is also to designate

the Manager, Vice-Manager and Chairman of this Board. As these appointees of each new administration are in their turn to appoint the chairmen of the various reserve bank boards, to select three of their nine directors, to have power to remove three others and to have authority to manage these banks to the extent of "determining" the rates of discount which they are to charge, the rates of interest which they are to pay, both for government deposits and for the use of government notes, and among other things when and how much they shall lend to each other, every new administration under the terms of the bill is to become in turn not merely the supervisor but practically the manager and administrator of the banking system of the country. One must be singularly blind to the teaching of history who believes that such management under our system of party government can continue long exempt from the suspicion of political influence or even from actual partisan abuse.

One may believe thoroughly in government control of banking and yet be utterly opposed to government management of it; and even if one believes in the management of banking by the government, one may still regard with extreme hostility the kind of management proposed in the House bill, —management by Cabinet members and administration appointees, whose tenure of office terminates with the changing administrations.

As regards the choice between government control and government management, I am inclined to think that what President Wilson said of the railroads some years ago in "The State" is equally true of the banks today: "The proposition that the government should control such dominating organizations of capital may by no means be wrested to mean by any necessary implication that the government should itself administer these instrumentalities. * * * * Indeed, such are the difficulties in the way of establishing and maintaining careful business management on the part of the government that control ought to be preferred to direct administration in as many cases as possible—in every case in which control without administration can be made effectual."

In the case of the House bill unfortunately it is not merely a question between government control and government management. We are confronted here not only with government management, but with management by a board of Cabinet

members and administration appointees, who in the very nature of the case, must be affected by the political aspects of things.

"In our country," said Mr. Paul Warburg recently—the German-American banker, who is probably more familiar than any other American with the relations between the banks and the government in continental Europe—, "In our country, with every untrained amateur a candidate for any office, where friendship or help in a Presidential campaign, financial or political, has always given a claim for political preferment, where the bid for votes and public favor is ever present in the politician's mind, where class prejudice and antagonism between East and West and North and South run high, in a country so different from the European states, a direct government management, that is to say political management, would prove fatal."

"Banking and politics are like oil and water. They do not mix," said Mr. James B. Forgan, the chairman of the committee recently sent to Washington by the Chicago convention of bankers. "The principles underlying sound banking are diametrically opposed to those which rightly or wrongly seem to control politics. In their fiduciary capacity, bankers, if they want to succeed and be faithful to their trust, must be constantly on their guard against the influence of such virtues even as friendship and human sympathy, and they must officially eschew the insidious influence of reciprocal personal favors. Such influences seem to be of the essence of politics and to control political activities."

"In the event of a district desiring some special consideration at the hands of the federal reserve board—such for instance, as requiring another district to re-discount for it—what more likely than that existing methods with other governmental departments should be followed and that the good offices of the Senators and Representatives in Congress of that particular district should be enlisted to see and to use their influence with the members of the board to secure from them the desired consideration."

The bill will remain utterly impractical and objectionable until the membership of the federal reserve board and the management of the reserve banks are completely divorced from the interests and vicissitudes of party politics.

Weakening of National Bank System.

Third, the compulsory feature still remains in the bill, and is still ominous for the continuance of the national banking system. The House Committee has tried to sugar coat the plan in various ways, but they have not even yet sufficient confidence in its acceptability to the bankers to leave it to the option of a national banker to subscribe or not, according to his judgment. Under the terms of the bill as it passed the House, the reserve requirements for member banks have been reduced by about twenty per cent. and as a further inducement to join, these banks have been offered two-fifths of the reserve banks' excess profits in addition to the five per cent. dividend. Nevertheless the administration leaders evidently realize that their plan does not appeal to the bankers, for they have not dared to make membership optional with the national banks. They have preferred to run the risk of wrecking the whole national banking system in order to diminish the risk of their own plan proving a fiasco. As a matter of fact there is little reason for country banks to subscribe for the proposed institutions as they can secure all of the advantages without expense or obligation through their city correspondents. Yet according to the terms of the House bill, they must either subscribe or reorganize under state charters. Reports from various sections of the country indicate that many national banks outside of the reserve cities would prefer to sacrifice their federal charters rather than submit to the requirements and provisions of the reserve bank system. If the bill is passed with the present objectionable features, it is also probable that many national banks within reserve and central reserve cities will either withdraw altogether from the national banking system and reorganize as state banks or trust companies, or what is more likely, will reduce their national banking capital and turn over a considerable part of their business to affiliated institutions under state charters. This latter method would allow them to secure the benefits and privileges of the reserve banks at a minimum of expense. But in either case it would mean a serious weakening, if not the extinction, of the national banking system.

Nondescript Note Issue.

Fourth, the note issue provisions are still unsound and inflationary. Under the terms of the bill the government is to be allowed to issue its notes to three times the amount of

the lawful money held by the federal reserve banks, but against these notes the government is not only required but is not allowed to hold any reserve whatever beyond a five per cent. gold fund which the bill authorizes the federal reserve board to require the reserve banks to provide. As the Treasury is obliged to deposit all of its general funds and revenues in the reserve banks it is legally estopped from holding more than this five per cent. reserve for the redemption of these notes. What is even more amazing absolutely no other gold reserve is required to be held even by the reserve banks. According to the terms of the bill the reserve banks must ordinarily hold "lawful money" to the extent of 33 1-3 per cent. of the notes deposited with them but the lawful money may consist of silver or greenbacks. In other words the reserve to be held by the federal reserve banks to redeem the new government notes may consist entirely of other government notes. Moreover it is not clear from the law that a reserve bank may not count as part of this reserve against the government notes the same 33 1-3 per cent. reserve of lawful money which according to section 22 of the bill it must hold against its own demand liabilities.

It is doubtful whether in any other civilized country today, including Central America and the Balkans, so nondescript a currency could be found—an issue of government notes which it is expected will amount to many hundreds of millions of dollars against which no reserve of gold is required to be held and which the issuing and responsible government is by law not allowed to hold a reserve of more than five per cent.

Some of the members of the Committee have argued that inflation is sufficiently guarded against in the bill by the provision in section 17, incorporated during the discussion in the House, that no reserve bank shall pay out notes issued through another reserve bank. They assume that this provision will prevent any more than a temporary addition to the currency through the new government notes, but as such notes issued through one reserve bank may not find their way to another reserve bank for years, and even when received by another reserve bank are to be returned at once to the reserve bank through which they were originally issued, and so may be immediately reissued, and as the tax to which they are subject may amount to no more than one-half of one per cent, per annum, there is no reason to expect that contraction will

follow any expansion of these notes. There is nothing to prevent their repeated reissue and their continuance in circulation to the extent of hundreds of millions if only the bank through which they are issued retains lawful money to one-third of their amount.

Some of the committee also seem inclined to the view that if inflation does tend to result from this new issue of government notes it will be offset by the retirement of national bank notes. But they overlook the fact that the federal reserve banks under the terms of section 4 are given power "to perform all those acts and to enjoy all those privileges" conferred upon national banks by section 5136 of the Revised Statutes, which includes "obtaining, issuing and circulating notes" according to the provisions of the national bank act. The federal reserve banks are apparently thus authorized not merely to act as agencies for the issue of the government federal reserve notes, but also to purchase government bonds and to issue their own notes in the same manner as national banks. If the adoption of the bill were to result, as many predict, in important withdrawals from the national banking system and the sale at much lowered prices of the government twos, one may anticipate that many of the released bonds would be purchased by the reserve banks and that notes would be issued by them to take the place of the notes relinquished by the national banks.

The House Committee therefore propose to make a real and permanent addition to our already redundant money supply of hundreds of millions of government paper money with provision for only a five per cent. reserve of gold, which moreover is only to be held at the option of the federal reserve board. The proposal seems to be "on all fours" with the greenback and free silver proposals of earlier decades and to have been inspired by the same erroneous theories. It is greatly to be hoped that it will experience a more expeditious fate.

Objections to Greenbackism.

One of the most important functions of government is to create and maintain the monetary standard, the measure of value by which all of the exchanges and payments and obligations of the country are settled, and the monetary history of this and every other country testifies to the dangers to which this standard is subjected by the issue of government

paper money. No foreign government has ever undertaken to issue notes without at some time over-issuing them and so degrading the standard of value, and the leading countries have therefore long since abandoned the issue of fiat money. The experience of this country with such money from earliest colonial days abundantly points the same lesson. It is unnecessary, however, to hark back to the lamentable experiences of Colonial and Revolutionary times. From the date of our last issue of government notes fifty years ago almost to the present day the outstanding government paper money has been a source of unsettlement to business and at repeated intervals even within the recollection of men not yet old these notes have menaced the very solvency of the Treasury. Generation after generation of sound currency advocates have sought to get rid of them, and the effort to do so has only subsided within the last decade because with the lapse of fifty years since their issue the amount of the remaining greenbacks has become relatively unimportant. No lesson of our history is plainer than that the government ought not to jeopardize its own credit and the people's standard of value by the issue of note obligations that are not covered dollar for dollar by gold. With the disgraceful and costly history of greenback and silver legislation so freshly in mind it would indeed be folly to begin again the issue of government credit notes at the present day. To attempt it with only a five per cent. gold reserve in the Treasury such as the House Bill proposes but does not even require, would be an unbelievable folly in this day and generation.

Inflationary Rediscount and Reserve Provisions.

Fifth, the bill makes possible not only a vast extension of credit in the form of government notes, but also a vast extension of credit in the form of ledger balances in the banks, and in neither case are there any provisions which require that these additional credit resources shall be kept in reserve for use only in times of special need. No restrictions are specified in the bill as to the powers of a member bank to rediscount its commercial paper with a reserve bank save in the character and maturity of this paper, and the character of the paper is loosely described as including not only all notes and bills the proceeds of which have been used for agricultural, industrial or commercial purposes but also all bills and notes which "may be" so used. There are few bills and notes

which conceivably "may" not be so used, and Mr. McAdoo has recently shown that the vast majority of the paper held by the national banks is within the maturity requirements of the bill. While the banks ought to be enabled to rediscount practically without limit in times of crises there ought to be some provision which would limit the amount of such rediscounts under ordinary conditions.

Moreover the bill reduces the cash reserve requirements of the country bank from 6 to 5 per cent., of the reserve city banks from 12½ to 9 per cent., and of central reserve city banks from 25 to 9 per cent., the total required reserves, including cash and balances with other banks being reduced as follows: for the country banks from 15 to 12 per cent., for the reserve city and central reserve city banks from 25 to 18 per cent. Now supposing that the bill were adopted and all of the national banks were included in the system, this would mean a reduction in the required cash reserve of the national banks of about $380,000,000 or 43 per cent. This estimate is based upon the reserve requirements as reported for June 14, 1912, the latest that I happen to have available, which may be summarized as follows:

	Present Required Cash Reserve	Proposed Required Cash Reserve	Proposed Reduction in Cash Requirements
Central reserve city banks	431,000,000	154,000,000	277,000,000
Reserve city banks	242,000,000	174,000,000	68,000,000
Country banks	203,000,000	169,000,000	34,000,000
	876,000,000	497,000,000	379,000,000

The only legitimate reason for this proposal to reduce the reserve requirements of the national banks is in order to provide a common reservoir of cash and credit for use in emergencies and periods of special stress. This is an altogether sufficient reason. The reserves of individual banks which hitherto have not been legally available even for the banks that held them are henceforth not only to be made available to these individual banks but are to be pooled and made available for all of the banks. In my opinion it would have been wiser to have gone further in this direction and to have made all of the cash reserves of the individual banks

legally available and mobilizable when required. But on the other hand there is a very crucial qualification to be borne in mind. These newly released reserves of lending power ought not to be put at the disposal of the banks in normal times. Otherwise we shall have inflation, and if the newly established reservoirs of credit are to be used and drained in periods of quiet, we shall have no better means of relief in periods of disturbance than we have today. In fact we shall be worse off for the resulting inflation is likely to cause an upsetting of our foreign trade balance which will draw upon our gold reserves as never before. In my opinion the present bill does not provide sufficient safeguards against such conditions. The individual banks are not restricted in the amount of rediscounts which they can normally obtain. Their cash reserve requirements are reduced by 43 per cent. or nearly $400,-000,000 This cash, and the $200,000,000 or so of government funds are to be turned into the reservoirs of the reserve banks and these banks in their turn can extend their credits threefold as they are only to be required to hold a reserve of lawful money of 33 1-3 per cent. against deposits. I believe that the reserve ordinarily to be held by the reserve banks should be far higher than 33 1-3 per cent. but that a provision should also be included which would make possible the use of any and all reserves in times of stress under such conditions as would insure their immediate restoration to the normal minimum when the stress was past.

Moreover the conditions under which these reserves might be used ought so far as possible to be automatic and predictable, and not left to the option of government officials, in order that business men and the banks could always forecast pending conditions and adjust their affairs thereto.

Such an arrangement could be easily provided through a tax upon any deficiency in reserves which would be so high during the first month or fraction thereof as to discourage their use except in periods of unusual need, and which would increase each succeeding month that the reserves remained deficient. This tax should also be accompanied by the requirement that so long as a deficiency in the reserves existed the minimum discount rate of the reserve bank should be maintained at not less than the rate of the tax. All such arrangements for the use of normally required reserves as well as for the issue of additional notes can be made by law

to work automatically, and it is as unnecessary as it is unwise to make their utilization and issue depend upon the opinion of any governmental committee.

In thus asserting that the House bill offers risks of vast inflation through the note issue and through inadequate reserve requirements, it is not by any means implied that the immediate effect of the adoption of the bill might not involve contraction in particular localities and the withdrawal of immense amounts of money, especially in the present reserve centers, from many lines of business. It is altogether probable that in the course of the redistribution of reserves as proposed many banks would temporarily find their lending powers seriously curtailed, and the business of many localities might be seriously disturbed. In the long run, however, and in the country at large, the danger of the bill lies in the possibility of inflation with the consequent possibility of serious depreciation.

Other Criticisms.

Among the details of the House bill are many other provisions open to criticism as inconsistent, ambiguous or unsound. It is for instance unclear from the terms of the bill whether a state bank can become a member of a reserve bank and still retain any of the functions and powers which a national bank could not possess. Again, the bill seems inconsistent in limiting, on the one hand, the rediscounts of a reserve bank to the government and the depositing and other reserve banks, and in allowing the reserve bank, on the other hand, to "purchase" bills from any individual, corporation or firm. Or once more, the bill seems unwise in permitting the member banks to share reserve bank profits in excess of five per cent. for this would incite rivalry and tend to promote expansion of business. Or, to cite only one more instance, it is very doubtful whether two successive examinations of any bank ought not, in order to be really effective, to be made by the same examiner. These and many other detailed objections to the bill I have passed over in order to emphasize the objections which seem fundamental. For the same reason I wish now to summarize these objections:

1. The proposal to establish "not less than twelve reserve banks" is objectionable because even if such a number could be organized, which is doubtful, they would only mobilize the limited reserves of twelve particular sections and not the reserves of the country as a whole.

2. The proposal to transfer to Cabinet officers and administration officials the control of interest rates, the disposition of the country's banking resources and other matters of bank management, is objectionable because it is practically certain to involve the whole system in partisan politics.

3. The proposal to compel national banks to become share holders in the reserve banks, with their present requiremets and methods of administration, is objectionable because it would in all likelihood seriously weaken, and it might completely wreck, the national banking system.

4. The proposal to issue additional Treasury notes, other than gold certificates, is objectionable because it is fraught with dangers which have been disastrously illustrated upon repeated occasions in the experience of this country. The note issue provisions of this bill are peculiarly objectionable because they are without safeguards against inflation or effective means to secure contraction.

5. The proposals with regard to rediscounts and reserves are objectionable because they are likewise inadequately protected against over expansion.

Erroneous Theories in Committee Report.

The general purposes of the bill as explained in the Committee's report in the main are sound. The sponsors for the bill evidently recognize the now generally understood desiderata of American banking—a more flexible and responsive note issue, more effective and economical reserve laws, the co-operative use of banking resources—objects of legislation which since the investigations of the Monetary Commission have been everywhere regarded as essential. One finds however in the Committee's report allusions to other objects of legislation which not only indicate confusion of thought about fundamental principles, but which lead to the proposal of some of the unrequired and dangerous remedies that we have instanced. One reads for instance (on page five of the Committee's report) that "all over the western world there is now a distinct shortage of capital, both fixed and floating" and that therefor the banks "should be enabled to do all that circumstances will permit in extending to the business world the volume of loans that it needs." Legislation, they add, "was never more urgently demanded than it is today" "which will furnish loans upon an inexpensive (sic) but absolutely safe basis." Such suggestions taken in connection with some of the provisions of the bill give ground for serious apprehension. The framers of the bill seem to be seeking, not merely to free the country from the extravagant interest rates that occur from time to time as a result of the collapse of our banking system, which is the real and legitimate purpose of banking reform, but they want also to lower interest rates normally and all of the time, to furnish loans, as they say "inexpensively" and to extend loans wherever "needed." Implicit in all this lurks the tenacious old error that has beset financial writers, one might say, ever since the world began—the belief that more money is needed to "promote manufactures" and to "improve trade." To answer this properly would require a rather more technical and intricate analysis than can be given in this place. I shall only outline the argument in a very few words. If, as the Committee seems to hold, there is not merely a temporary stringency of money capital but a general shortage of all kinds of real capital the world over, the real reason is either that capital has been destroyed or that wealth is being unproductively consumed in too large proportions, in a word, that not enough of the world's annual product is being saved and devoted to further production. Sometimes the same apparent effect may result from an insufficiency merely of floating capital, due to the fact that a disproportionate quota of the accumulating capital of the country has been invested in fixed forms, especially in such forms as require the absorption of future accumulations in the same fields. These are situations which intermittently appear in most rapidly growing countries, and it is one of the oldest and most persistent of fallacies that such situations can be remedied by merely adding to the mechanism of exchange. It of course is not true, as the Committee apparently suppose, that more railroads, factories, office buildings and the like (fixed capital) can be created, or that more coal and raw materials (floating capital) can be supplied if only more paper money and credit can be provided. Yet unfortunately the proposals of the Committee both with regard to the issue of notes and with regard to the extension of credit in other forms are tinctured wtih this idea. Regardless of the fact that the whole world has suffered for a generation and is still suffering from an excessive money supply, the consequences of which are reflected in the ever rising cost of living, the Committee has apparently not escaped the erroneous theories of the greenback and free silver advocates, and proposes to better the situation by providing for the issue of indefinite millions

of government notes as well as for an extension of millions of credit in other forms at the option of the government officials.

Although the existing banking system is gravely defective it is greatly to be hoped that the Senate will resist all pressure to revise it until the present measure has been purged of its more glaring and fundamental deficiencies. The dogged adherence of some of the Democratic leaders to the errors in the banking bill against which the enlightened opinion of the whole country is protesting, is not surprising when one recalls the decades of greenbackism and of 16 to 1, but it is very unfortunate for the country. If the present bill is pushed through Congress with these unsound and precarious features, inflationism and political banking, which ought only to be considered in the cool white light of reason, will, like greenbackism and free silver in the past, be for decades the centers of heated political controversy, and the present plan, if adopted, will necessarily be made the subject of radical revision as soon as the Republicans again come into control.

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